

# *Strategic Analysis*

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## **JOBLESS RECOVERY IS NO RECOVERY: PROSPECTS FOR THE US ECONOMY**

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### **Introduction**

The US economy grew reasonably fast during the last quarter of 2010, and the general expectation seems to be that satisfactory growth will continue in 2011–12. This report argues that the expansion may indeed continue through 2012, and perhaps for another quarter or so in 2013. But with large deficits in the government and foreign sectors, satisfactory growth in the medium term cannot be achieved without a major, sustained increase in net export demand. This, of course, cannot happen automatically, and it certainly will not happen without either a cut in the domestic absorption of goods and services in the United States or a revaluation of the currencies of the major US trading partners. Both might impart a deflationary impulse to the rest of the world, while the latter might also cause a resumption of inflationary pressures.

Following our usual custom, we make no short-term forecast. Instead, using the Levy Institute's macro model, which is rooted in a consistent system of stock and flow variables, we trace a range of possible medium-term scenarios in order to evaluate strategic predicaments and policy options, without being at all precise about timing.

### **The Current State of the US Economy**

The new Republican Congress has changed the rules of how policy will be formed, at least for the next two years. Early legislative deliberations are firmly fixed on cutting the budget deficit—after having achieved a compromise with the White House in continuing President Bush's tax cuts for some government transfers and payroll withholding—so that any talk about fiscal stimulus

receives no consideration, and is even subject to ridicule. Hence, the burden of fighting high unemployment seems to have fallen mostly on the shoulders of the Federal Reserve. A second round of quantitative easing (QE2)—the purchase of long-maturity assets by the Fed—was announced in November 2010, and is an attempt to engineer a loosening of the credit markets and spur growth and employment. But what could be the effects of this second push by the Fed? They might be similar to those of QE1, and an analysis reveals the following. In November 2008, the Fed announced large-scale purchases of mortgage-backed securities and debt issued by government-sponsored enterprises (GSEs). Its securities holdings began to climb sharply in early 2009. As shown in Figure 1, the monetary base (a broad measure of the Fed’s liabilities) had already begun to rise several months prior to that, while new asset purchases for QE1 ended in 2010.

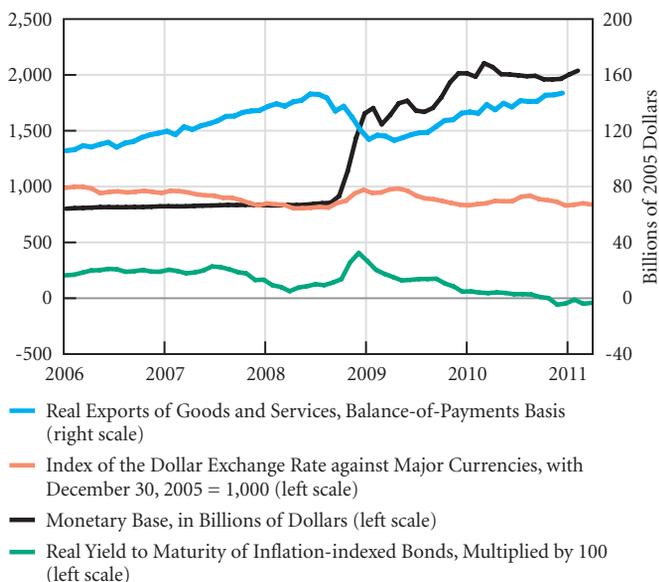
The effects of QE1 and the other stimulus policies adopted by the Fed since late 2008 have not been welcome in many quarters both here and abroad, and their merits will be debated for some time to come. Notably, however, a trade-weighted index of the dollar’s value against a basket of foreign currencies has declined quite a bit (see Figure 1). This development has provoked captious commentary, especially from some world leaders; but it may in fact have helped spur real (infla-

tion-adjusted) US exports, as shown by the blue line in Figure 1. The figure also shows the yield on a 10-year inflation-indexed Treasury security, which can be used as a measure of the real interest rate. This rate has tumbled from well over 3.5 percent to negative levels. Contrarians doubt that the Fed’s strategy can succeed in reducing long-term interest rates over a prolonged period—its remarkably sustained trend notwithstanding.

The expansionary fiscal policy initiated by President Obama (Blinder and Zandi 2010), reinforced by an accommodative and even aggressive monetary policy that has kept (real) short-term interest rates at zero percent and long-term rates very low, have brought the “Great Recession” to an end. Yet, with all this help, the recovery from the recession of 2008 has not been robust, as confirmed by stubbornly high levels of unemployment and underemployment. Over the next few years, policy and market developments are likely to prove important for the performance of the US economy. Growth and employment, in particular, have been far below the levels of productive potential, and there is a widely accepted view that most of the policy shifts under way will turn out to be not only ineffective but also counterproductive.

The experience drawn from efforts to reduce budget deficits in Europe could be seen as lessons in ineffective and counterproductive policy. Greece, Ireland, the United Kingdom, Portugal, and Spain—all of these countries are implementing tax increases and drastic spending reductions, in the form of cuts in public sector wages, government workforces, and social spending. Meanwhile, the financial system continues to create new demands on the public purse in Europe, where the member governments of the eurozone lack the power to conduct independent monetary policy suited to their needs. Notably, many large banks on the Continent and in Britain hold significant amounts of bonds from countries such as Greece, Ireland, and Portugal that may default on many of their obligations. Separately, a mortgage crisis similar to the one in the United States has developed in the Irish banking system that has led many depositors to suddenly withdraw funds (Krugman 2010). Bondholders are still skittish, and yields on many European government bonds have climbed significantly, notwithstanding the European Central Bank’s large purchases of government bonds and its lending to troubled eurozone banks. The leaders of Ireland have joined those of Greece in agreeing to an international bailout effort, and

**Figure 1 Possible Effects of Quantitative Easing**



Sources: St. Louis Federal Reserve Bank, FRED database; authors’ calculations

pressure is being applied to Portugal to follow suit. However, opposition to these efforts remains strong in much of Europe, since these bailouts require even more draconian austerity measures.

Here at home, many key interest rates are already at or near record lows, a very unusual situation attributed partly to the Fed's unconventional policy measures (D'Amico and King 2010). While the Fed's relaxed monetary strategy is certainly beneficial, it will not be the motor for economic growth and employment. In sectors of economic activity that are usually regarded as "interest rate sensitive" (e.g., housing construction), the Fed's policy has had minimal results. Research by Macroeconomic Advisers, LLC, shows that even an additional \$1.5 trillion dollar bond purchase by the central bank would reduce unemployment by only two-tenths of a percentage point (Hilsenrath 2010). Low interest rates notwithstanding, many firms seem to be sitting on large stocks of cash, waiting for demand for their products to rebound. Moreover, there is increasing tension over exchange rates among the governments of many of the world's largest economies. This has led to admonitions from many finance ministers around the world that they see quantitative easing as an unfair effort to "manipulate" the value of the dollar, as if policymakers had set some obvious target value for the exchange rate. Some countries are now acting independently to devalue their currencies in order to improve their trade balances. Certainly, this will be of help domestically to many depressed economies, but it will complicate US efforts to reduce the value of the dollar against other currencies. Indeed, the United States and other countries may find themselves printing large amounts of money simply to maintain the competitiveness of their exports, and even then face the risk of being branded as mercantilist nation-states.

Many members of the new Republican-led House of Representatives were elected after campaigns in which they advocated sharp cuts to government bureaucracies, an end to federal deficits, and even a return to the gold standard (Green 2010). But we find some solace in polls showing that deficit reduction constitutes the top policy priority for only 4 percent of the electorate (CBS 2010), even though the radical antigovernment contingent is a vocal and highly motivated voter group. We nevertheless fear that, with a divided Congress, nothing new and dramatic in the way of economic policy will occur. To be sure, mainstream economic thinking, including

that of the Congressional Budget Office (CBO) and the president's advisers, continues to adhere to a "stimulate now, cut the deficit over the long run" approach to fiscal policy during a recession. They are relatively cautious in their policy proposals, despite the fact that unemployment remains extremely high by historical standards. In the simulations reported in this report, we use the CBO's forecasts for some economic variables, but even these begin with the unrealistic supposition that the economy is likely to heal itself in a baseline scenario without major new stimulus packages. Like many antideficit groups and politicians, the CBO adopts a somewhat alarmist tone and makes some assumptions that inflate their projections of future federal debt levels (Galbraith 2010).

Recently, the leaders of the bipartisan deficit-reduction commission put forward an initial proposal that calls for \$4 trillion in budget cuts. These include deep reductions in spending for bread-and-butter programs—including Social Security, which helps people of modest or low income afford necessary purchases. It is often forgotten that this program helps reduce poverty, a goal that is especially crucial at a time when work and family resources are scarce for an unusually large number of Americans. Other fiscal austerity proposals from Congress and middle-of-the-road nonprofit organizations call for a freeze on domestic discretionary spending (e.g., see BPC 2010). (The term "discretionary" is used to refer to spending that is not mandated by Social Security eligibility rules or other laws, but rather allocated in every year's federal budgeting process.) These misguided plans mostly "backload" spending cuts, but they involve the enactment of some spending cuts within one or two years and encourage an unfortunate presumption on the part of the public that stimulus measures should be off the agenda for the foreseeable future.

Some of the "investments" made under the Troubled Asset Relief Program and other bailout programs have proven to be profitable, but huge liabilities continue to accumulate for others. These ongoing problems foster the impression that there is already plenty of crisis-related spending, though official measures in unemployment indicate that full recovery is far from accomplished and many needs that are more immediate and pressing remain unaddressed. While the fiscal stance is likely to tighten further at the federal level, fiscal troubles remain severe at the state and local levels in much of the United States. Budget cuts are planned this year and next in

places such as New York City, which recently announced that it would reduce its educational workforce by about 5,400 people (Reddy 2010). Even new bond issues from the State of California are received with skepticism by many investors, and the new Democratic governor is acting in concert with his Republican predecessor, who reportedly said that he must ask for cuts to not only the fat in the state budget but also the bone (Aneiro and Woo 2010).

Finally, as the global economy begins to revive, huge amounts of excess reserves in the private banking system and in sovereign portfolios around the world have generated destabilizing bubbles in commodity and financial markets. Already, capital inflows in some emerging economies have raised fears that the ground was being laid for a repeat of the late-1990s Asian financial crises. Many of these crises began with the bursting of asset bubbles created by foreign investment. At this point, the possibility of future asset booms is not among this nation's pressing concerns, but it reminds us that we need a better basis for a broad-based and sustainable economic recovery. Moreover, an uptick in inflation led by speculation in asset markets could abruptly end efforts by some central banks to promote higher growth rates and avert a new recession.

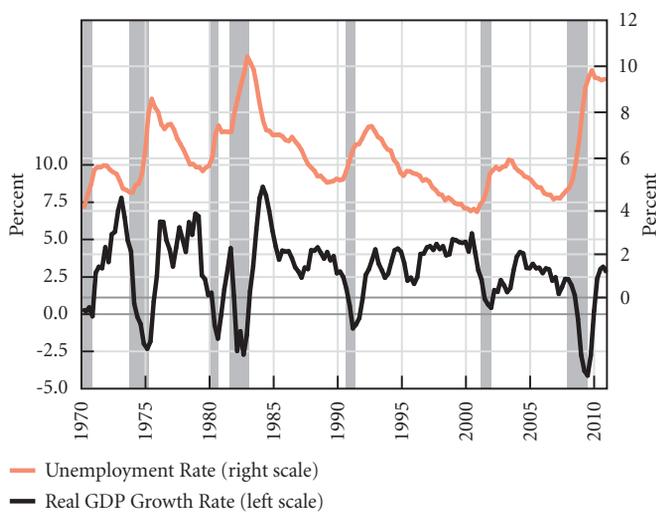
A closer look at the data will tell us about the economic challenges now facing US policymakers.

### More Precisely

It is by now well known that the US economy has lost millions of jobs since the start of the Great Recession, and the ranks of the unemployed and underemployed remain still at stubbornly high levels. This, despite the National Bureau of Economic Research's Business Cycle Dating Committee, the arbiter of business cycles, having declared that the recession ended in June 2009.<sup>1</sup> Figure 2 shows the dynamics of real output and the corresponding unemployment rates since 1970. It can be seen that the Great Recession has been the longest, and has generated the largest increase in unemployment. Even in the 1981 recession, when the unemployment rate reached 10.8 percent, it began rising from a low of 5.9 percent at the end of 1979—a net increase of 4.9 percent. In 2007, unemployment stood at 4.4 percent and climbed to 10.1 percent—a higher net increase of 5.7 percent. (Our figures are reported on a quarterly basis and do not show the January and February 2011 unemployment rates, which showed some improvement.)

The rise in unemployment mirrors the drop in jobs. Post-World War II employment as a share of the working-age population (14–64) has fluctuated but has generally followed the trend shown in Figure 3. When the 2007 recession began, employment was very much below trend, with no visible prospects of resuming its trend. In earlier recessions (shaded areas), once recovery began, employment rehabilitation soon followed. In the 1990, 2001, and 2007 recessions, structural

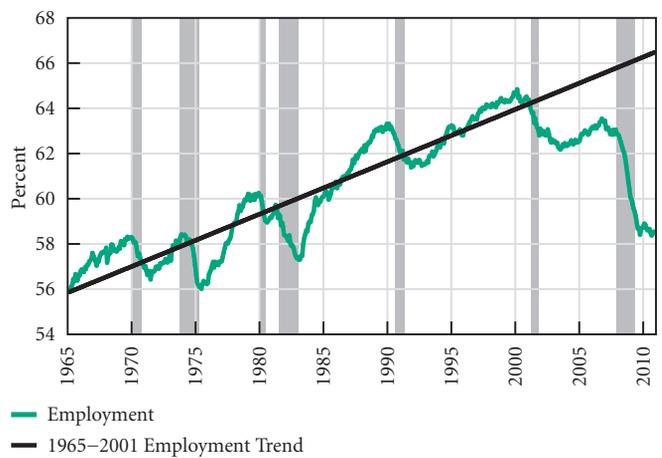
**Figure 2 GDP Growth and Unemployment Rates**



Note: Shaded areas indicate recession.

Sources: Bureau of Economic Analysis (BEA); Bureau of Labor Statistics (BLS)

**Figure 3 Employment as a Share of Working-age Population**



Note: Shaded areas indicate recession.

Sources: BLS; authors' calculations

changes affected the reaction of employment to output, progressively so. Notice that in the 1990 recession, employment began falling somewhat before the downturn's official beginning, and kept falling for some time after the recession ended. This phenomenon intensified in 2001, and is similar to the 2007 recession as well.

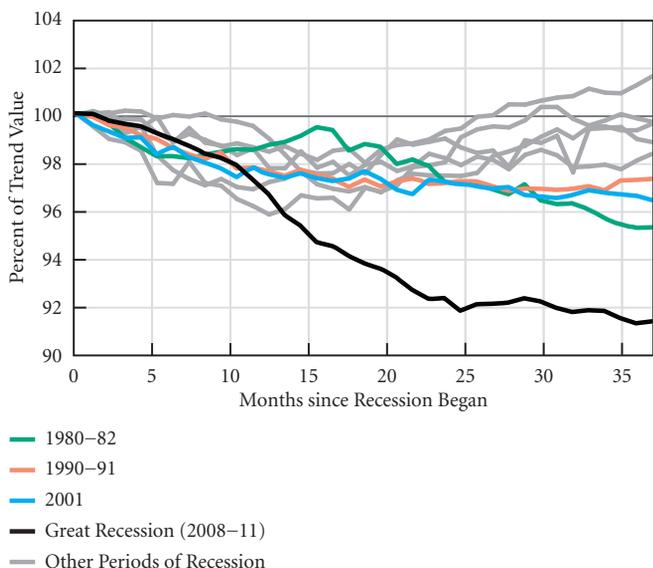
More than seven million jobs have been lost since the last employment peak in November 2007, and, as of last December, about 19 million jobs need to be created for employment to return to its prerecession trend, adjusted for increases in the current population. A comparison of employment trends for all postwar recession periods<sup>2</sup> shows that the effects of recession on employment do not vanish after three years (the only exception being the 1969 recession), and that employment usually remains below its trend (Figure 4). But in December 2010, three years after the Great Recession began and a year and a half after it officially ended, employment was still below trend by more than 8 percent, or 19 million jobs. Significant improvement in the employment situation is not in the offing, as the Bureau of Labor Statistics report for February shows (BLS 2011). The results from a household survey indicated a very small decline in the unemployment rate, to 8.9 percent, while a separate survey of businesses found a total

increase of 192,000 employees on US payrolls last month. In the household survey, approximately one million people, or about 0.6 percent of the labor force, said that they wanted to work but were no longer bothering to look for a new job because of a lack of employment opportunities. Over 5 percent of the labor force was working part-time while searching unsuccessfully for full-time employment.

The evolution of the US economy in 2010 has been in line with our latest projections (Zezza 2010). In our December 2009 Strategic Analysis report (Papadimitriou, Hannsgen, and Zezza 2009), we argued that the US government should postpone any measures to reduce the federal deficit. Our simulations, conditional on the same assumptions, proved to be extremely accurate in projecting employment but overly optimistic in terms of real output growth, unless the final estimate is revised upward.

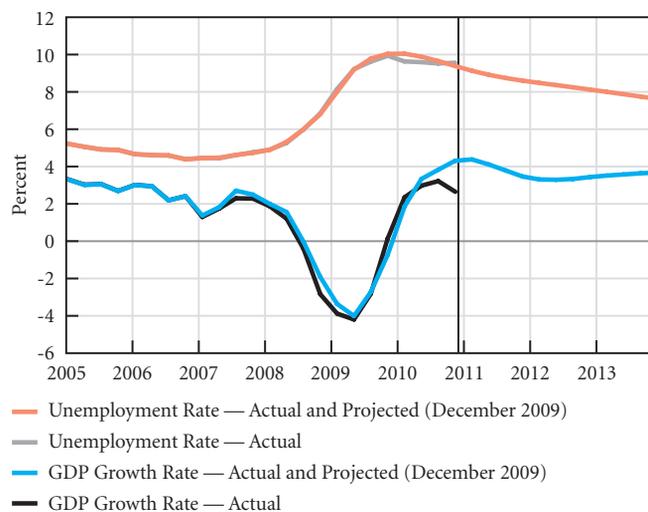
We also assumed that household net borrowing, already in negative territory, would level off as a share of income, while borrowing by firms would slowly return to positive values—which is roughly the situation now. These assumptions, together with our assumptions regarding the direction of housing prices and the stock market and the path of fiscal policy and net exports, implied that the economy would recover, but with a high, and slowly declining, unemployment rate (Figure 5). (In the last section of this report we will adopt a

**Figure 4 Employment in Recessions (beginning of recession = 100)**



Sources: BLS; authors' calculations

**Figure 5 GDP Growth and Unemployment Rates**



Sources: BEA; BLS; authors' calculations

similar set of assumptions to update our projections for the prospects for the US economy in the medium term.)

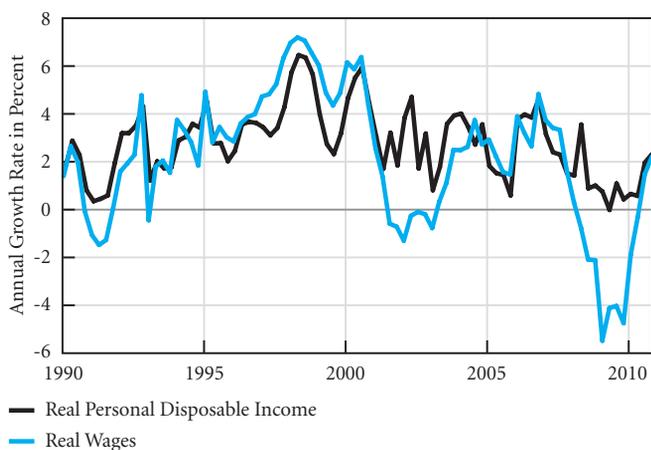
The major determinants of consumer spending—at 70 percent the largest component of GDP—are now steadily improving. Real wages have grown in the last two quarters, after more than two years of precipitous decline (Figure 6), although they are still about 4.7 percent below their prerecession level. This recent growth is attributed to a moderate rise in the real wage per worker following the decline at the onset of the recession and the brief period of stagnation that followed. Real wages, of course, are affected by employment increases, and this is reflected in the numbers for the last two quarters. Since the dynamics of real wages per worker can differ substantially among worker groups—with jobs in the finance and management sectors seeing most of the gains in recent decades<sup>3</sup>—the effects of a rise in real wages on aggregate demand may be lower than what one might initially think.

The other major gauge of consumer spending is disposable income. During this recession, real disposable income has been sustained by a fiscal intervention that helped prevent a further deterioration in consumption that would have impaired growth substantially more, as shown in Figure 6. Figure 7 shows personal taxes, along with several subcategories of personal income: government transfers to individuals; employee compensation; and personal income (including proprietors' income, rental income, and income from assets) net of transfers.

Real disposable income has been sustained by a dramatic fall in tax payments and large increases in transfer payments—both significantly greater than what was registered in the 2001 recession. These are partly due to the recession—when unemployment increases, so do payments for unemployment benefits, et cetera—and also to specific government interventions put in place by the Obama administration. As the figure shows, both effects—the drop in tax revenues and the rise in transfers—have begun to level off, with current transfer receipts now at the prerecession level. If these trends continue, taxes and transfers will not provide further stimulus to income and consumption.

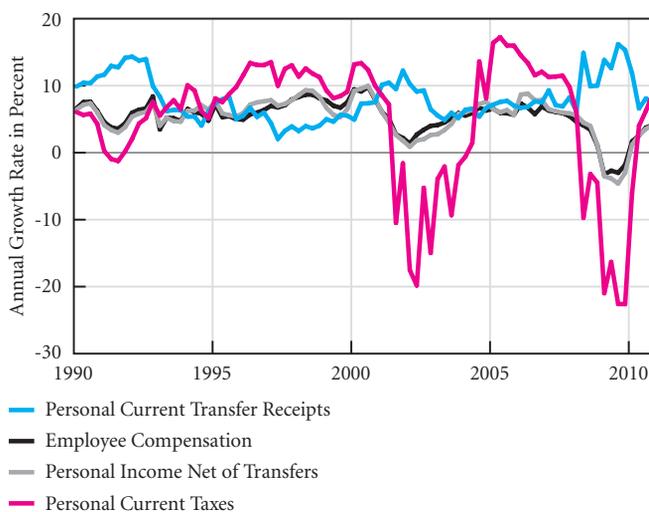
Household borrowing has remained negative, while it was a major driver of the sustained aggregate demand boom of the 2000s (Figure 8). Together with foreclosures, negative borrowing is responsible for the decline in the stock of household debt outstanding, which fell to 117.6 percent of personal disposable income from its peak of 130 percent in the third quarter of 2007. It has been suggested that the decline in borrowing does not necessarily imply a change in consumer attitudes toward credit but is, rather, the statistical outcome of the recent wave of bankruptcies and the resulting increase in the number of loans written off by the institutions that held them (Whitehouse 2010). If this were the case, we would, presumably, witness a sharp fall in the income and spending data for specific groups of individuals who were more likely to take

**Figure 6 Real Personal Disposable Income and Wages**



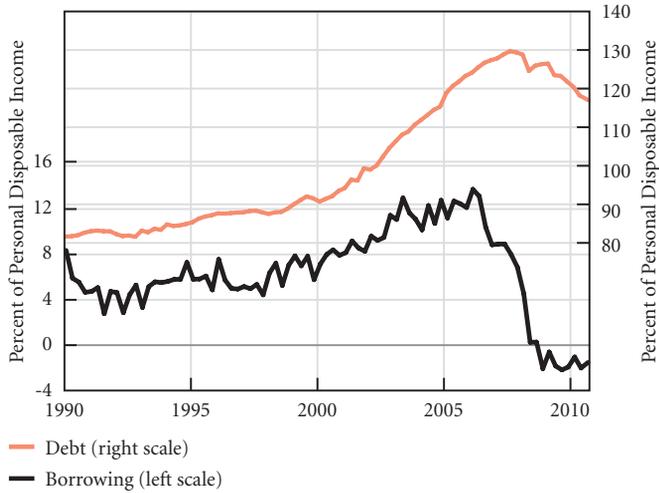
Source: BEA

**Figure 7 Determinants of Personal Disposable Income**



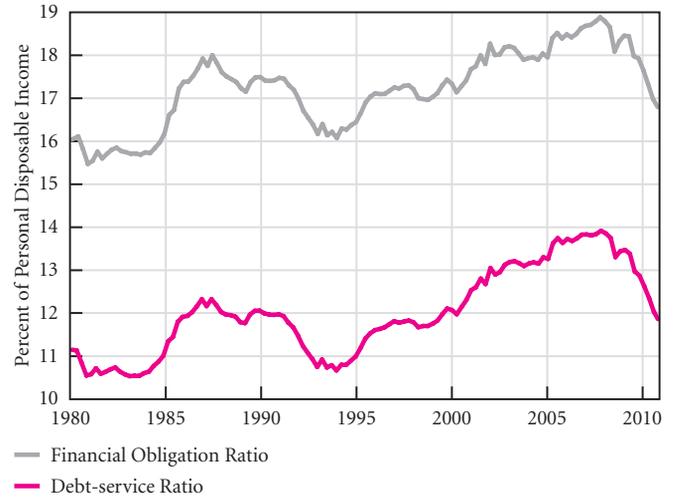
Source: BEA

**Figure 8 Household Borrowing and Debt**



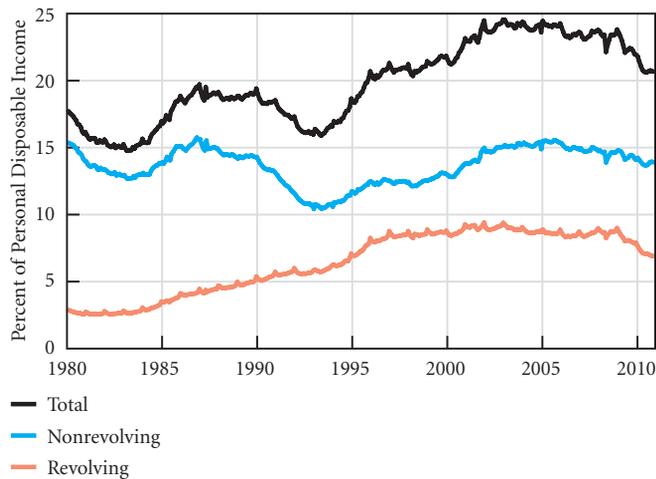
Sources: Federal Reserve; BEA

**Figure 10 Debt Burden**



Source: Federal Reserve

**Figure 9 Consumer Credit Outstanding**



Sources: Federal Reserve; BEA

out mortgages or loans they could not afford, but not for social groups that were less affected by the mortgage crisis—assuming that credit were still available to them. A plausible outcome of this scenario would be a small increase in the average saving rate of US households. To the contrary, the saving rate has increased dramatically—as we will discuss later—an observation that is more in line with the view that households have changed their habits and not simply defaulted on much of their debt.

**Figure 11 Propensity to Save Out of Disposable Income**



Source: BEA

Changes in consumer spending habits are evident in the data on consumer credit shown in Figure 9. Both revolving and nonrevolving credit have been falling relative to disposable income since the beginning of the recession, with the largest share of the drop from their August 2007 peak recorded in 2010, after the official end of the recession the previous year. We have argued, however, that what may matter most for consumers' decisions is not the level of debt outstanding, but rather the debt burden relative to disposable

income. The overall debt burden has been declining steadily since the recession began (Figure 10) and is now below its 2000 level, prior to the bursting of the dot-com bubble and the start of the housing market frenzy. The shrinking debt burden is undoubtedly a joint consequence of the decline in total debt outstanding and low interest rates. Given that the stock of debt is still high relative to GDP, a word of caution is necessary here, since any rise in interest rates would quickly reverse the downward trend. Assuming that very low interest rates continue, further reductions in debt outstanding should boost consumer confidence.

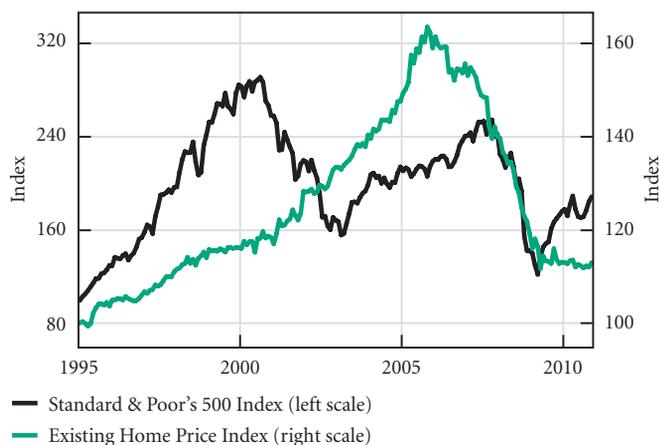
As mentioned above, the household saving rate has increased significantly since the recession began. The propensity of households to save out of disposable income, after declining to an all-time low in 2005, has now jumped to about 6 percent of GDP—a level close to its value in the first half of the 1990s, though still much lower than its peak of almost 12 percent in the early 1980s (Figure 11).

Rising assets, whether equities or housing, play a critical role in the ability of households to borrow and spend. The boom in equity prices was undoubtedly a major force behind the rise in spending during the dot-com bubble, as was the run-up in home prices prior to 2006. A widely used measure of equity prices, the Standard & Poor 500 Index, along with a measure of prices in the housing market, both deflated by a general price index for consumer goods, are depicted in Figure

12. The recent data on these indexes show divergent trends after 2008, with the stock market index recovering rapidly and the housing market remaining stagnant. Overall, the evidence points to a modest increase in the pace of consumption, especially if real disposable income continues to rise, and an even larger increase with the implementation of government policies to sustain income, such as this year's cut in payroll taxes.

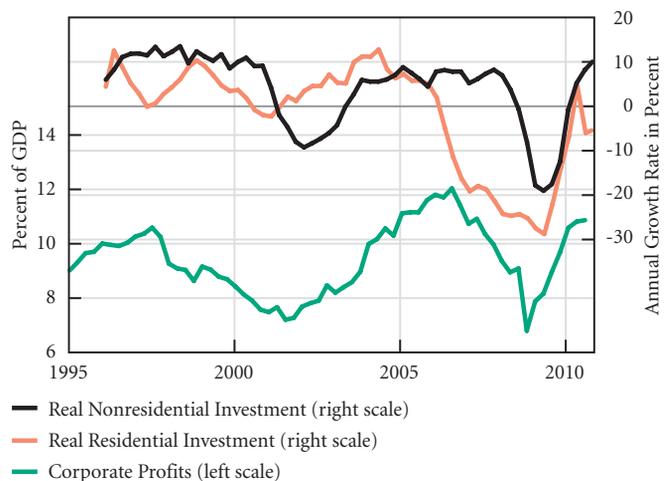
Real investment, both residential and nonresidential, began growing again in the second quarter of 2010 after a long and dramatic fall (Figure 13). The largest increase in nonresidential investment, however, was for transportation equipment (56 percent in the last quarter of 2010 over the same quarter in 2009), fueled by specific measures that have now expired. Other components of investment also grew, including “equipment and software” (16 percent) and “other industrial equipment” (18 percent); these increases were not necessarily due to macroeconomic policies. Irrespective of these significant increases, the level of nonresidential investment is still 12 percent below its prerecession peak in the first quarter of 2008. On the other hand, the growth in residential investment shown in Figure 13 may be due to resales of foreclosed houses, together with the end of the downward slide in residential property values. The latter have stabilized in real terms since late 2009 but remain substantially (58 percent) below their peak in late 2005, and even below the average for the 2000s. The figure also illustrates a simple measure of aggregate profits.<sup>4</sup>

**Figure 12** Indexes of the Real Prices for Equities and Existing Homes (1995M1=100)



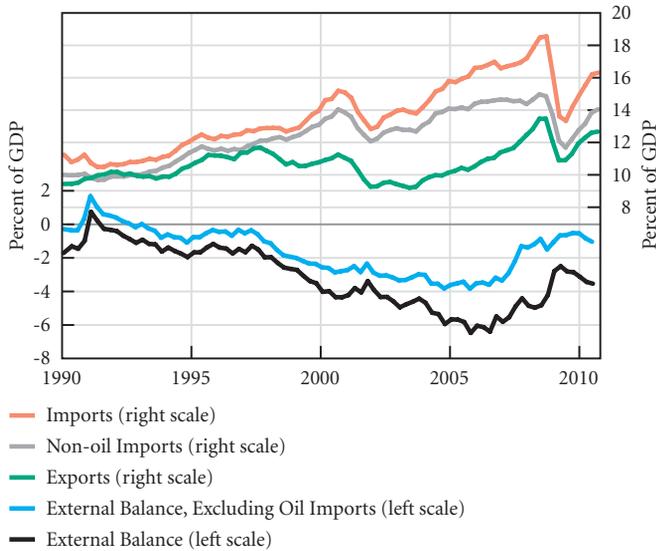
Sources: S&P; National Association of Realtors

**Figure 13** Profits and Investment



Source: BEA

**Figure 14 US Balance of Payments on Current Account**



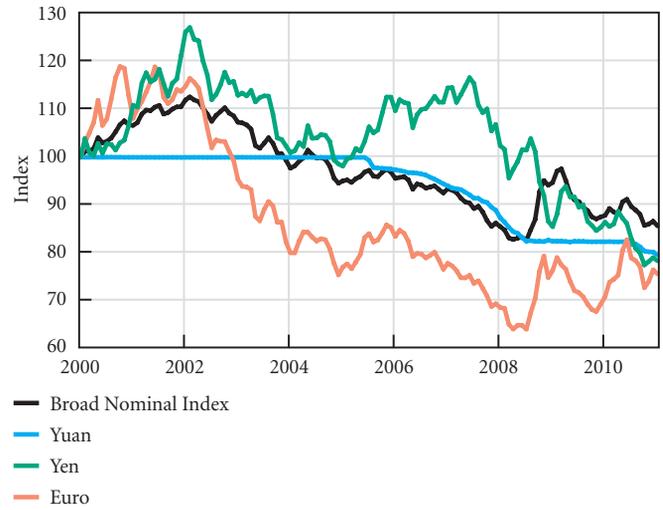
Source: BEA

Casual observation of the trends depicted seems to suggest that there is a lagged response of nonresidential investment to profits.<sup>5</sup> It can be surmised, then, that the recent surge in corporate profits, should it continue, may be an important factor in aggregate demand growth, since no stimulus can be expected from residential investment anytime soon.

The effects of net exports, foreign debt, the value of the dollar, and international imbalances on the economy are also of crucial importance. The US external balance and its component parts are shown in Figure 14. In the last 20 years, net exports have been a drag on aggregate demand, with imports systematically surpassing exports. Buoyant domestic demand in the United States, combined with a strong dollar, generated a large and growing external trade deficit, which peaked at 6.4 percent of GDP in 2005, with the largest share (now 3.8 percent) being non-oil trade. Since then, the non-oil trade deficit has begun to drop while the ratio of oil imports to GDP has remained relatively stable, fluctuating between 1.5 and 3.8 percent of GDP. The dollar's decline against other currencies (Figure 15) helped close the (non-oil) deficit, reinforced by the effects of the recession having hit the United States more severely than its trading partners.

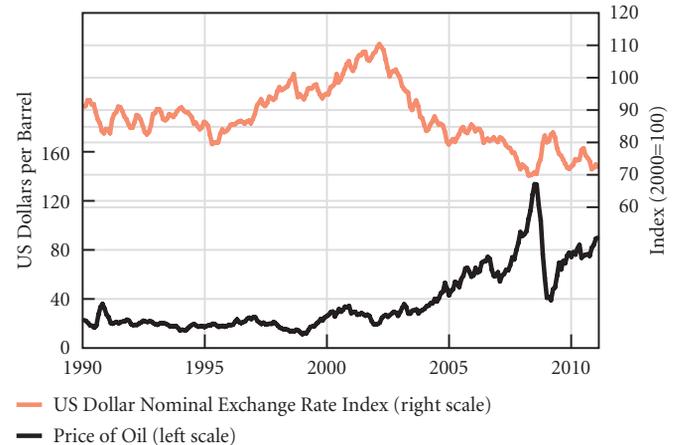
If oil imports are excluded, the US external balance is now close to a deficit of 1 percent of GDP, with the overall

**Figure 15 US Dollar Exchange Rate Index (2000=100)**



Source: Federal Reserve

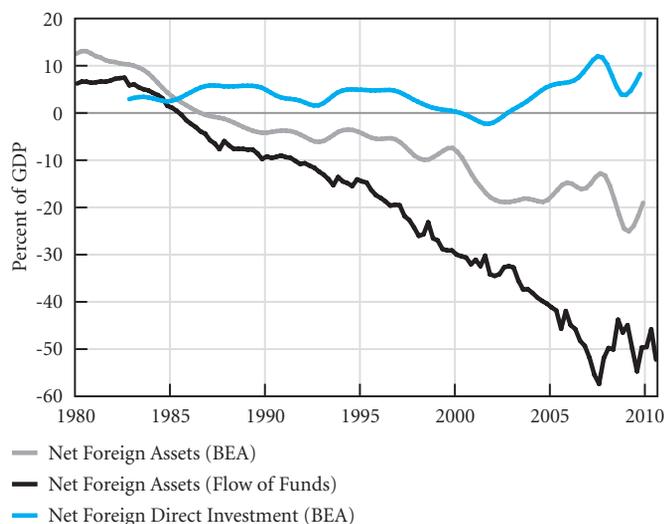
**Figure 16 US Dollar Nominal Exchange Rate Index**



Sources: US Energy Information Administration; Federal Reserve

external balance at 3.5 percent of GDP (see Figure 14). Oil imports are clearly a major factor in US net current payments to the rest of the world. Movements in the price of oil are therefore quite important, and seem to be linked to the dynamics of the US dollar. Figure 16 plots the aggregate, trade-weighted nominal index of the dollar's value, along with a measure of the international price of oil. After 2001, oil prices move in the opposite direction to the value of the dollar: the correlation between the two figures is zero before

**Figure 17 US Net Foreign Assets**



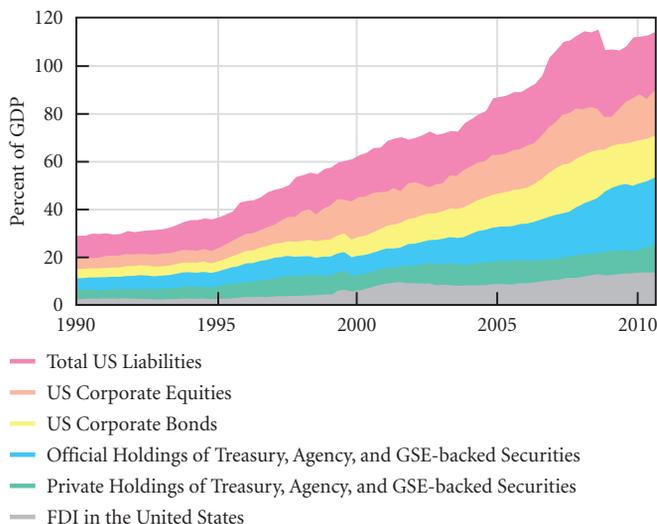
Sources: Flow of Funds; BEA

2001, and minus 0.8 from 2002 to 2010. Dollar devaluation, or expected dollar devaluation, will push the international price of oil upward, a fact that is consistent with oil exporters diversifying their reserves away from the US dollar and/or interested in other currencies not pegged to the US dollar. A devaluation of the US dollar, though effective (as we will argue later) in improving the overall trade balance, will not necessarily reduce the cost of US oil imports.

A growing trade deficit carries the implication that the net foreign debt rises accordingly. The black line marked “net foreign assets” in Figure 17, drawn from the Fed’s latest Flow of Funds report (FRB 2011), shows that this sum had fallen to roughly minus 50 percent of GDP in the third quarter of 2010. This line reflects assets and liabilities at cost rather than at market price, and does not, therefore, consider exchange rate changes affecting the dollar value of assets denominated in other (appreciated) currencies. In contrast, the gray line, drawn from Bureau of Economic Analysis data (BEA 2010a), depicts the same history using market prices. This series now stands at about minus 20 percent of GDP.

The United States is in an enviable position: not only can it borrow from abroad in its own currency but it can also buy assets denominated in strong currencies, or currencies that are expected to appreciate. Therefore, since external deficits—sooner or later—reduce the value of the currency of the

**Figure 18 US Foreign Liabilities**

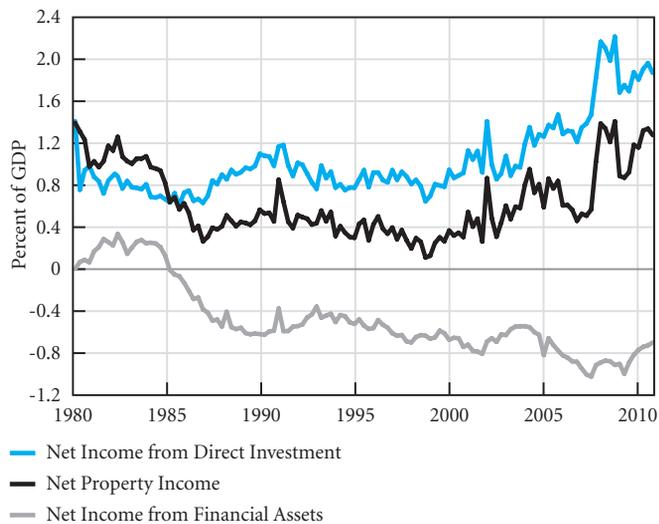


Sources: Flow of Funds; BEA

deficit country, the United States experiences capital gains on its foreign financial assets denominated in nondollar currencies—while the value of its dollar-denominated financial liabilities does not change. The gray line shows estimates of this effect based on information from the “US Net International Investment Position” as reported by the BEA.<sup>6</sup> The blue line, marked “net foreign direct investment,” illustrates how net stocks of direct investment (at current values) have fluctuated upward, reaching 8 percent of GDP in the third quarter of 2010. Apparently, foreign direct investment (FDI) has a life of its own, independent of trade imbalances or movements of the US dollar. American companies continue to invest in foreign markets at a faster pace than foreign companies do in the United States.

Data from the Federal Reserve and the BEA show that irrespective of the Fed’s relaxed monetary stance and the downward pressure on the dollar, foreign central banks and others are still willing to buy and hold dollar-denominated assets, as detailed in Figure 18. It is interesting to note that a major increase is registered in official holdings of US Treasury and other government securities—which have risen to 26 percent of US GDP, up from 7 percent in 2000—while private holdings of these assets have increased from 6 percent to only 11 percent of GDP during the same period. A large increase is also shown in foreign holdings of US corporate bonds, which

**Figure 19 Net Income Payments from Abroad**

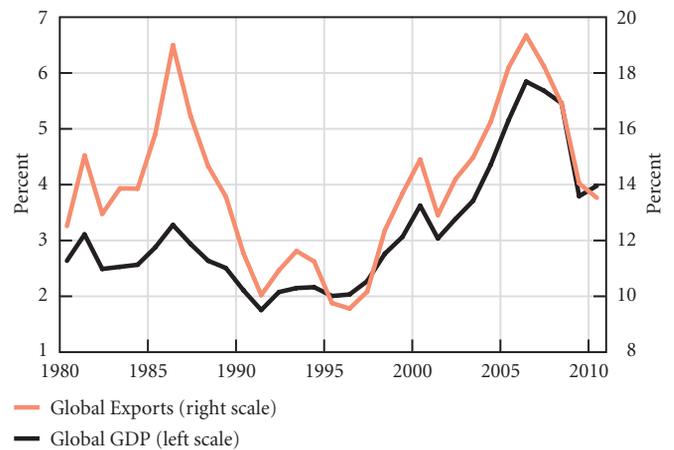


Source: BEA

now stand at 17 percent of GDP—a big jump from the 2000 level of 7 percent of GDP. US corporate equity holdings held by foreigners, valued at cost, equaled 15 percent of US GDP in 2000 (before the dot-com crash) and were at the same value in the second quarter of 2010, although they are now increasing again. This leads us to conclude that the demand for safe US assets is primarily from overseas central banks rather than foreign investors wishing to diversify their portfolios. This observation poses a serious challenge to the notion that foreign accumulation of US assets is a consequence of an overseas “saving glut.”

Figure 19 shows the net flows of income associated with the various asset categories. Although the stock of US foreign debt has increased considerably, its impact on interest payments has not been dramatic so far, mainly due to the decline of interest rates. Net interest payments for foreign liabilities other than FDI have increased to 0.7 percent of GDP. On the other hand, the US benefits from large income flows on FDI, on a scale that is puzzling.<sup>7</sup> US net property income from direct investment is 1.9 percent of GDP, and more than offsets interest payments on its outstanding foreign debt. This may be due to accounting incentives for US-based corporations with operating units abroad to repatriate comparably higher profits, while overseas firms operating in the United States (with perhaps lower profits) choose not to do so.

**Figure 20 Indexes of Global Imbalances**



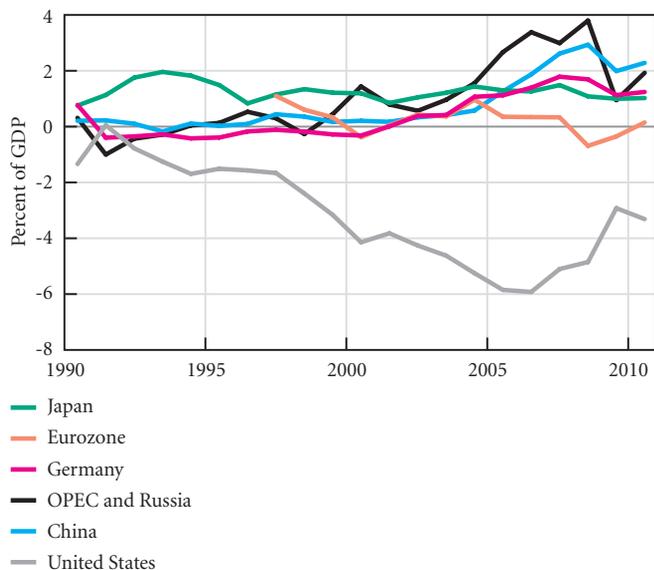
Source: IMF

We can obtain a simple measure of the ex-post rates of return on foreign investment by dividing the reported flow-of-income payments from the BEA to the initial stock of FDI valued at current costs. The conclusion from such a calculation is that the return on FDI in the United States is very low in comparison to the return US investors earn abroad.

The indexes of global imbalances shown in Figure 20 are constructed using the mean of the absolute values of the current account balances of 169 countries<sup>8</sup> and scaling them in relation to both world GDP and total world exports, with all variables measured in current US dollars. The indexes cover a 30-year period (1980–2010), with 2010 data—and at times, 2009 data—projected by the International Monetary Fund (IMF 2010b). Countries with missing data after 1992 were taken out of the sample. The chart shows that, in spite of the index’s decrease during the Great Recession, there are still many countries spending more than their income and relying on other countries to finance the imbalance.

The current account balances of some key US trading partners have moderated since the start of the Great Recession. Similarly, the US current account deficit decreased to about 3.6 percent of GDP from its all-time high of 6.3 percent in 2005. Figure 21 reports the current account balance of various countries and groups of countries as a percentage of US GDP. As we observed in Figure 14, the United States

**Figure 21 Balance of Payments on US Current Account**



Sources: BEA; IMF

continues to face a significant challenge in rectifying its trade deficit, a large part of which is made up of oil imports.

Looking more closely at Figure 21 through the exchange-rate lens of Figure 15, we cannot fail to notice that the devaluation of the dollar against the euro has been effective in reducing the US trade deficit with the eurozone. The (smaller) revaluations of the Chinese yuan and Japanese yen have been less effective. The deficit with OPEC trading partners and Russia is sizable, and, as we observed earlier, highly dependent on the movement of oil prices. Japan and Germany rely heavily on exports, but the eurozone as a whole is now roughly in balance, since Germany's surplus is offset by the deficits of the other member countries.

### Three Strategic Scenarios

Underlying the main conclusions of this Strategic Analysis is an econometric model in which exports, imports, taxes, and public and private expenditures are functions of world trade, relative prices, tax rates, stocks of debt, and flows of net lending. In what follows, we present projections of US economic performance between now and 2015. These projections are not forecasts, especially not short-term forecasts. We have

exercised care to ensure that they are consistent with recent developments and with a significant number of the indicators that we have presented above. Our interest in making these conditional projections is to describe major strategic challenges, broadly conceived, that are likely to arise over the next five years, and to consider alternative strategies to deal with them.

### Baseline Scenario

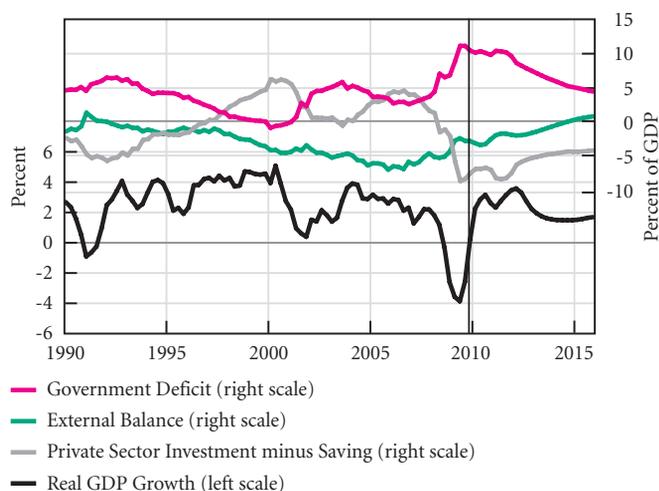
Our baseline scenario has been constructed, as usual, using a set of assumptions that is as neutral as possible. Our projections for output and inflation in US trading partners is from the IMF "World Economic Outlook Update," issued in July 2010 (IMF 2010a). In addition, we adopt the revised CBO projections for fiscal policy that imply a declining deficit for the federal government (CBO 2011). Assuming that state and local government deficits stabilize in terms of GDP, we replicate the CBO dynamics of fiscal policy for the US general government. Since the CBO's projections are based on the current state of legislation, they include the recently enacted compromise bill, which includes a two-year extension of the Bush tax cuts, reductions in payroll taxes, and extensions of unemployment benefits, as well as other changes to government expenditures and transfers.

We assume that households keep paying down their debt, although at a slower pace, while nonfinancial businesses get back to positive net borrowing. These assumptions are not inconsistent, in our view, with the latest figures on credit, which show only a modest increase in consumer debt outstanding for December 2010 and January 2011, following several months of decline. The latest data on the stock of mortgages, which is much larger than the sum of outstanding consumer credit, are consistent with our assumptions.

We further assume a stable US dollar exchange rate as well as stable interest rates and relative prices, including the price of oil—although this assumption may prove faulty given the recent spike in oil prices due to the political upheavals in the Middle East. Should the situation in these countries deteriorate, the path of the financial balances would change dramatically. We nevertheless remain optimistic that things will calm down and prices will return to their pre-upheaval level.

CBO projections frequently underestimate the future path of government deficits. In recognition of this bias, the revised projections (CBO 2011) attempt to correct it by

**Figure 22 Baseline Scenario: US Main Sector Balances and Real GDP Growth**

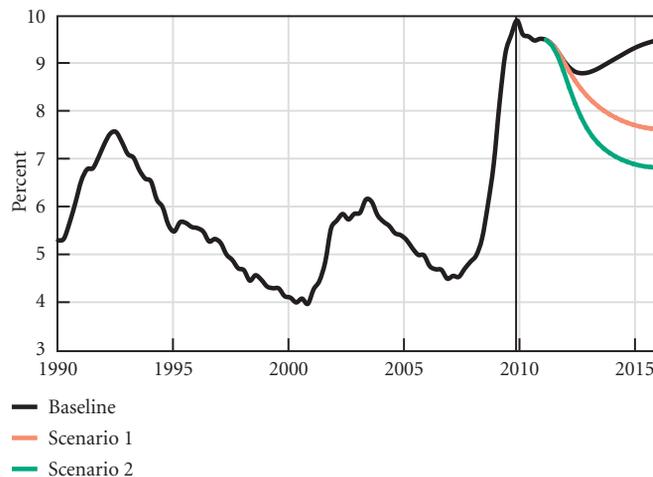


Source: Authors' calculations

providing an alternative projection for the government deficit. Under the CBO's hypothesis of a "continuation of certain policies,"<sup>9</sup> the projected deficit stabilizes at around 4.6 percent of GDP in 2015.

In our baseline scenario, the main sector balances slowly move toward sustainable levels: by the end of the simulation period, the external balance is zero, private sector net saving goes back to about 4.6 percent of GDP—still high with respect to its prebubble average—and the budget deficit, also at 4.6 percent of GDP, becomes a mirror image of private sector net saving (Figure 22). These projected sectoral balances are broadly in line with the CBO's GDP projection, with our measure of the public sector deficit at all levels of government going down by 5.4 percent of GDP by the end of the simulation period in 2015. The two-year relaxation of fiscal policy contributes to an increase in the real GDP growth rate (to about 3.8 percent), but economic growth declines subsequently as a result of the expiration of the fiscal stimulus in 2012. The increase in taxation and moderation in government expenditure in that year will reduce GDP growth slowly, to just below 2 percent by 2015. This is a scenario of "growth recession," in which unemployment declines to 8.6 percent at the beginning of 2012 but then increases and stabilizes at a high, and undesirable, level of about 9.4 percent by the end of the simulation period (Figure 23). Our own assumptions take

**Figure 23 Unemployment Rate in Three Scenarios**



Source: Authors' calculations

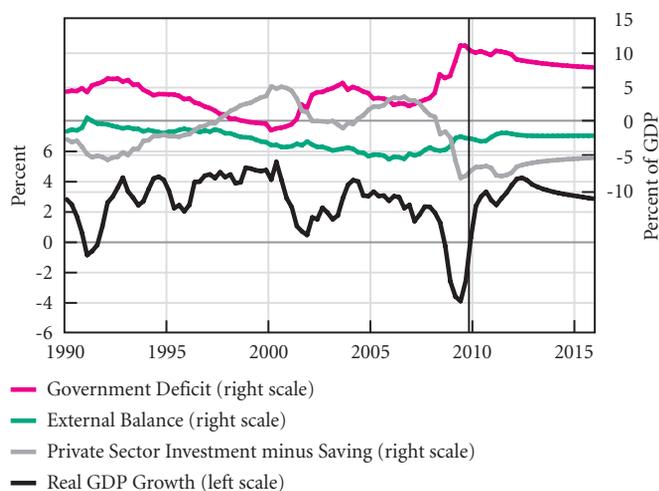
into consideration our belief that the slowdown in US growth will not have a large impact on US trading partners and that slower growth in the United States will improve the US external balance, which will reach zero by 2015. Government debt will not decrease, since the government deficit, as a share of GDP, remains higher than the GDP growth rate for most of our simulation period. The deficit, however, will tend to stabilize as a share of GDP, and both foreign and private sector debt will decrease as a share of GDP.

To sum up, the simulations in our baseline scenario, using neutral assumptions about what is likely to happen and the revised CBO projection of fiscal policy under current legislation, show that the private sector will continue to reduce its debt and the external deficit will disappear, but unemployment will stabilize at a high level. The simulations also show that the current attempt to address the public deficit "problem" by cutting spending will not meet with success.

### Scenario 1: An Enhanced Fiscal Stimulus

Viewing the results of the baseline scenario simulations, we think it is inconceivable that things would turn out as depicted, especially during a presidential election season in 2012. Reducing unemployment would become urgent, as will spending on infrastructure, education, research and development, and other government investment. In our "enhanced fiscal

**Figure 24 Scenario 1: US Main Sector Balances and Real GDP Growth**



Source: Authors' calculations

stimulus” scenario, we project the outcome of deferring the adjustment to the public sector deficit assumed in the baseline scenario. We assume that government expenditure continues to grow, in real terms, at its prerecession average (2 percent for government expenditure on goods and services, and 4 percent for government transfers<sup>10</sup>), and that tax rates are kept at their current level. All other assumptions remain the same as in the baseline scenario. Figure 24 illustrates the possible outcome for the three financial balances under these assumptions. Output grows faster in this scenario, allowing unemployment to drop just below 8 percent (Figure 23) by the end of the simulation period. Faster growth, on the other hand, results in a larger foreign deficit, which exceeds 2 percent of GDP.

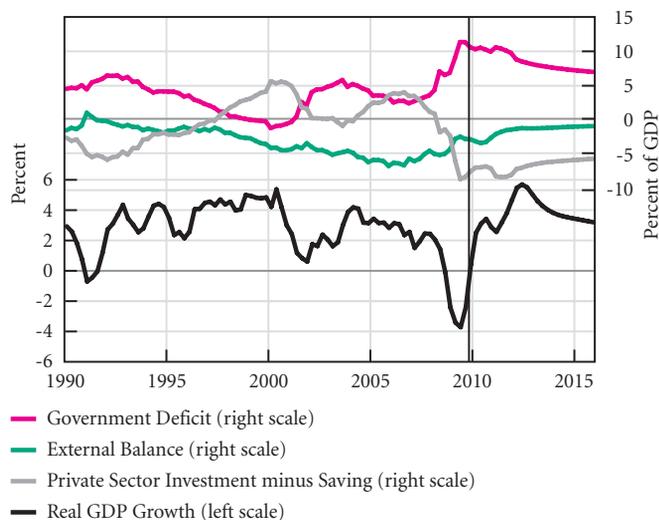
The main points to be made about this scenario are, first, the relaxation in the fiscal policy (compared with what is now projected by the CBO) would have to be so large that the general government deficit would rise to over 7.8 percent, an increase of more than 3 percent from the baseline scenario. Second, if unemployment is to be significantly reduced, by our reckoning, there would have to be a fiscal stimulus much larger than the one assumed.

### Scenario 2: Filling the Gap in Aggregate Demand with Exports

Three strategies can be put in place to fill the gap in aggregate demand and reduce unemployment: stimulating private investment, trying to bring about an increase in net exports, or relaxing the government’s fiscal stance. Several commentators point out that the most likely effect of QE2 will be on the value of the US dollar. A dollar devaluation will reduce the cost of US exports in foreign markets, and increase the dollar price of US imports: the first effect will directly contribute to US aggregate demand, while the second effect may be beneficial to domestic demand if it stimulates import substitution. A likely price to pay for dollar devaluation is that—when expectations of a devaluation increase—speculators invest in commodities priced in dollars, such as oil, driving up the price of such commodities. Since the amount of US oil imports is still large, at 2.4 percent of GDP, increases in the price of oil will prove to be costly, in the short term, for US balance of trade, and possibly for domestic prices—although the correlation between the price of oil and domestic prices in the United States seems to be much weaker than in previous decades.

But what would be the most effective way to increase US net exports? If we look at the breakdown of US trade by country/region (Figure 21) and compare it with changes in the US dollar exchange rate (Figure 15), we see that exchange rate movements are not sufficient to close trade gaps with individual countries. Relative to 2000, the dollar is now devalued by about 20 percent against the yen—with most of the devaluation in the last three years—yet the trade deficit with Japan has remained relatively stable at 0.5–1 percent of US GDP. The devaluation against the yuan is about 24 percent, with most of it occurring in the last two years, but the trade gap with China has widened. Only the dollar’s devaluation against the euro, which started earlier, has been recently associated with an improvement in the US trade balance with members of the eurozone. These figures seem to suggest that a revaluation of the currency of surplus countries may be more effective in closing trade gaps than a general devaluation of the dollar. Besides, if devaluation is brought about by an increase in liquidity provided by the Fed, which is then channeled by international monetary markets toward countries with relatively high rates of return, the currencies that will appreciate are not necessarily those of surplus countries. The Chinese government,

**Figure 25 Scenario 2: US Main Sector Balances and Real GDP Growth**



Source: Authors' calculations

which can control or prohibit short-term capital inflows into its financial markets, may hold the power to prevent monetary easing in the United States from affecting the value of the yuan.

A coordinated realignment of currencies—or, even better, some reforms of international monetary institutions—would therefore be preferable to a devaluation of the dollar, and proposals for reforms are being discussed more and more frequently.<sup>11</sup> But reforms take time and may not be feasible in the short term. Therefore, exchange rate movements—or the introduction of tariffs—seem a more likely way out in the short term.

In our export-led growth scenario, we examine the effects of a devaluation of the US dollar against all other currencies, as measured by the broad exchange rate index published by the Fed. Since the exchange rate index of the dollar against other major currencies is almost at a historic low, such a devaluation will imply in our model that the euro (and the yen) will rise to very high values, imparting a deflationary impulse to these areas. The eurozone absorbs US exports in an amount equal to 3 percent of US GDP, so a slowdown in this area will offset at least part of the effects of the dollar's devaluation against the euro.

We assume a devaluation of 10 percent starting in the second quarter in 2011, with no effects on the price of commodities, including oil. Our simulations show that the impact

on trade will be substantial by the end of the simulation period, with the United States achieving a deficit of 1 percent of GDP (Figure 25). The government deficit will also improve, falling to 6.7 of GDP, since higher GDP growth (exceeding 5.5 percent in 2012 and slowing thereafter to 3 percent) and lower unemployment imply larger revenues and less public expenditure. However, the impact of the devaluation on GDP implies an additional reduction in the unemployment rate of 0.8 percentage point, and is therefore not sufficient to change the United States' path toward stagnating growth.

## Conclusions

Our policy message is fairly simple, and consistent with that of previous Levy Institute Strategic Analyses—a fact that is not coincidental, given that events over the years have tended to vindicate the approach we have advocated since the late 1990s (e.g., see Godley, Izurieta, and Zezza 2004). The years since this series began have seen huge amounts of private and public borrowing (albeit with their relative proportions shifting over time). Since this century began, most commentators, policy-oriented economists, and political leaders have argued for reductions in government borrowing, but few have pointed out the potential instabilities that could arise from a growth strategy based largely on private borrowing. The recent financial crisis has shown that Hyman P. Minsky (2008 [1986]) was right to criticize an unstable system in which policy permits private debt to explode. A return to normalcy will occur only if US companies find customers other than domestic ones. As the *Financial Times*' Martin Wolf (2010) put it,

The crucial point is that the US can reduce its huge fiscal deficits, without pushing the country into a deep slump, if and only if other sectors expand spending, relative to incomes. This is unlikely to happen in the US private sector, to a sufficient extent, though some expansion of investment is plausible. A good part of the needed adjustment must come from expansion of foreign spending relative to income—in other words, a reduction in the structural current account deficit.

Hence, we have often suggested measures to reduce the trade deficit, including devaluations (e.g., Papadimitriou, Hannsgen, and Zezza 2008). The current account balance has improved and seems to be righting itself, even in our baseline scenario. So far, however, this return toward balance has occurred mostly as a reaction to financial collapse and a deep recession, not as a result of successful economic policy.

Ideally, countries with large surpluses should focus on increasing their populations' consumption levels. In the absence of an internationally coordinated stimulus, though, aggressive domestic policy is crucial for countries that are running current account deficits. Domestic monetary and fiscal stimulus measures have helped and continue to do so (Blinder 2010; Blinder and Zandi 2010). With the economy operating at far less than full employment, we think Americans will ultimately have to grit their teeth for some hair-raising deficit figures, but they should take heart from recent data showing record-low "core" CPI inflation (Dougherty 2010). In the next few months, policymaking will be hampered by political rhetoric and realities in Washington, and hence deficits will probably remain far below the levels needed to bring about a strong recovery. On the other hand, export-led growth has the potential to begin reducing unemployment. Given the likely political tenor of the new Congress, we consider only a moderate fiscal stimulus in this analysis, finding that growth prospects are somewhat improved in a scenario combining a stimulus with devaluation. Specifically, the unemployment rate declines to about 7 percent by the end of our simulation period. While the policies tested in scenario 2 can only be described as stopgap measures, they could prevent a downward financial and economic spiral. Hence, it will be important for President Obama and Congress to negotiate a mutually acceptable fiscal expansion, despite the difficulties involved in doing so with a divided legislature.

## Notes

1. See NBER (2010a, 2010b).
2. For an analysis of employment in recessions, see also Shierholz (2011).
3. See Arestis, Fontana, and Charles (2011).

4. For corporate profits with inventory valuation and capital consumption adjustments, see National Income and Product Accounts Table 1.12, line 13 (BEA 2011).
5. This observation has been confirmed by exploratory econometric analysis, which shows a long-run response of investment to profits of about 0.5—that is, an increase in real profits of 1 percent implies a long-run increase in investment of 0.5 percent.
6. As an example of the relevance of changes in the value of assets, consider the US stock of financial assets (excluding derivatives) at year-end 2008, which were equal to \$13.1 trillion, or 93 percent of GDP (BEA 2010b). The value of financial assets at year-end 2009 was \$14.9 trillion, or 103 percent of GDP, with the \$1.8 trillion increase due to net purchases of new assets (\$140 billion, or 8 percent of the increase), price appreciation of existing assets (\$1.1 trillion, or 61 percent of the increase), and exchange rate changes that led to a change in the dollar value of assets (\$358 billion, or 20 percent of the increase). The residual \$185 billion is due to other reasons, such as changes in coverage or capital gains/losses of direct investment affiliates, or changes in positions that cannot be allocated to financial flows or fluctuations in either prices or the exchange rate. For US liabilities, 32 percent of the increase from 2008 to 2009 was due to new debt and 56 percent to the increase in the market value of US assets held by foreigners. Only 8 percent of the increase was due to exchange rate movements.
7. See Gourinchas and Rey (2005) for a discussion of this phenomenon.
8. The countries in the index are: Albania, Algeria, Angola, Antigua and Barbuda, Argentina, Armenia<sup>1</sup>, Australia, Austria, Azerbaijan<sup>1</sup>, The Bahamas, Bahrain, Bangladesh, Barbados, Belarus<sup>1</sup>, Belgium, Belize, Benin, Bhutan, Bolivia, Botswana, Brazil, Brunei Darussalam<sup>5</sup>, Bulgaria, Burkina Faso, Burundi, Cambodia<sup>4</sup>, Cameroon, Canada, Cape Verde, Central African Republic, Chad, Chile, China, Colombia, Comoros, Democratic Republic of Congo, Republic of Congo, Costa Rica, Côte d'Ivoire, Croatia<sup>1</sup>, Cyprus, Denmark, Djibouti<sup>2</sup>, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eritrea<sup>1</sup>, Ethiopia, Fiji, Finland, France, Gabon, The Gambia, Germany, Ghana, Greece, Grenada, Guatemala,

Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Hong Kong SAR, Hungary, Iceland, India, Indonesia, Islamic Republic of Iran, Ireland, Israel, Italy, Jamaica, Japan, Jordan, Kazakhstan<sup>1</sup>, Kenya, Kiribati, Korea, Kuwait, Kyrgyz Republic<sup>1</sup>, Lao People's Democratic Republic, Latvia<sup>1</sup>, Lebanon, Lesotho, Libya, Lithuania<sup>1</sup>, Former Yugoslav Republic of Macedonia<sup>2</sup>, Madagascar, Malawi, Malaysia, Maldives, Mali, Mauritania, Mauritius, Mexico, Moldova<sup>1</sup>, Mongolia<sup>2</sup>, Morocco, Mozambique, Myanmar, Namibia<sup>3</sup>, Nepal, Netherlands, New Zealand, Nicaragua, Niger, Nigeria, Norway, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Portugal, Qatar, Romania, Russia<sup>1</sup>, Rwanda, Samoa, São Tomé and Príncipe, Saudi Arabia, Senegal, Seychelles, Sierra Leone, Singapore, Slovenia<sup>1</sup>, Solomon Islands, South Africa, Spain, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sudan, Suriname, Swaziland, Sweden, Switzerland, Syrian Arab Republic, Taiwan Province of China, Tajikistan<sup>1</sup>, Tanzania, Thailand, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan<sup>1</sup>, Uganda, Ukraine<sup>1</sup>, United Arab Emirates, United Kingdom, United States, Uruguay, Uzbekistan<sup>1</sup>, Vanuatu, Venezuela, Vietnam, Republic of Yemen<sup>3</sup>, Zambia, Zimbabwe. (<sup>1</sup>From 1992; <sup>2</sup>from 1991; <sup>3</sup>from 1990; <sup>4</sup>from 1986; <sup>5</sup>from 1985.)

9. See CBO (2011), 21–24, and Figures 1-4 and 1-5. “The projected deficit with the continuation of certain policies is based on several assumptions: First, that provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, or 2009, or that modified estate and gift taxation do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare’s payment rates for physicians are held constant at their 2011 level” (CBO 2011, 16).
10. Our model endogenously determines some transfers that depend on the business cycle (e.g., unemployment benefits), so our assumption is related to other transfers.
11. See Zoellick (2010) and Zhou (2009), among others.

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